82-1525

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ALEXANDER L. STEVAS,
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No.

IN THE

Supreme Court of the United States

October Term, 1982

CRC CORPORATION,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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QUESTION PRESENTED FOR REVIEW

Whether the court below correctly construed Section 636 of the Internal Revenue Code of 1954, as amended, 26 U. S. C. § 636, in holding that an oil or gas production payment (which Congress, in response to tax avoidance allowed by the previous tax law under the ABC transaction, has mandated be treated as a mortgage loan) does not provide basis, and is not accruable, because the uncertainties of hydrocarbon production make the production payment contingent, even though the Treasury Regulations promulgated at the direction of Congress which define a production payment specifically recognize the necessarily contingent nature of a production payment—"if, as and when produced"—and, notwithstanding the contingency, prescribe loan treatment for the production payment for both deduction and income attribution purposes.

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PETITION FOR WRIT OF CERTIORARI

Petitioner CRC Corporation respectfully prays that a Writ of Certiorari be issued to review the judgment of the United States Court of Appeals for the Third Circuit entered in this proceeding on November 16, 1982.[1]

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1. CRC Corporation is a wholly owned subsidiary of Adobe Oil and Gas Corporation, which corporation, in turn, has the following additional subsidiaries: Adobe Oil Company; Adobe Holland, Inc.; Adobe International, Inc.; Adobe Marketing Corporation; Adobe Mining Company; and Adobe Royalty Inc.

OPINIONS BELOW

The Opinion of the United States Court of Appeals for the Third Circuit filed on November 16, 1982 was published at 693 F. 2d 281 (1982) and is set forth on pages A27 through A32 of the separate Appendix filed herewith pursuant to Rule 21.1(k). The Order of the United States Court of Appeals denying Petitioner's Application for Rehearing or Rehearing En Banc is unpublished but is set forth on page A34 of the separate Appendix hereto. The Opinions of the United States Tax Court which underlie this proceeding are published at 73 T. C. 491 (1979) and 74 T. C. 1062 (1980) and are set forth at pages A35 through A195 of the separate Appendix hereto.

STATEMENT OF JURISDICTION

The judgment of the United States Court of Appeals for the Third Circuit sought to be reviewed was dated and entered on November 16, 1982. The Order denying Petitioner's Petition for Rehearing was entered on December 10, 1982. This Court has jurisdiction to review the final judgment of the Court of Appeals pursuant to 28 U. S. C. § 1254(a)(1).

STATUTORY PROVISION INVOLVED

The Internal Revenue Code of 1954, as amended, 26 U. S. C. § 636 provides:

"§ 636. Income tax treatment of mineral production payments.

"(a) Carved out production payment.—A production payment carved out of mineral property shall be treated, for purposes of this subtitle, as if it were a mortgage loan on the property, and shall not qualify as an economic interest in the mineral property. In the case of a production payment carved out for exploration or development of a mineral property, the preceding sentence shall apply only if and to the extent gross income from the property (for purposes of section 613) would be realized, in the absence of the application of such sentence, by the person creating the production payment.

"(b) Retained production payment on sale of mineral property.—A production payment retained on the sale of a mineral property shall be treated, for purposes of this subtitle, as if it were a purchase money mortgage loan and shall not qualify as an economic interest in the mineral property.

"(c) Retained production payment on lease of mineral property.—A production payment retained in a mineral property by the lessor in a leasing transaction shall be treated, for purposes of this subtitle, insofar as the lessee (or his successors in interest) is concerned, as if it were a bonus granted by the lessee to the lessor payable in installments. The treatment of the production payment in the hands of the lessor shall be determined without regard to the provisions of this subsection.

"(d) Definition.—As used in this section, the term 'mineral property' has the meaning assigned to the term 'property' in section 614(a).

"(e) Regulations.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section.

"Added Pub. L. 91-172, Title V, § 503(a), Dec. 30, 1969, 83 Stat. 630, and amended Pub. L. 94-455, Title XIX, § 2906(b)(13)(A), Oct. 4, 1976, 90 Stat. 1834."

STATEMENT OF THE CASE

On August 16, 1976, the Commissioner of Internal Revenue issued a Notice of Deficiency for the 1972 tax year of Petitioner CRC Corporation, which Notice placed in issue the tax treatment accorded its investment, both as general partner and as limited partner, in exploratory and developmental oil and gas drilling, especially as that treatment related to deduction of intangible developmental and drilling costs (26 U. S. C. § 263) arising out of payment made via nonrecourse notes/production payments (26 U. S. C. § 636). A timely Petition was filed with the Tax Court. Upon completion of the pleadings and discovery phases of the case, and following a series of pretrial Orders, the case came on for trial before Judge Cynthia Holcomb Hall [2] from January 8 through 18, 1979 and from February 6 through 9, 1979. At the close of these 13 days of bench trial, having heard 41 witnesses and having accepted, pursuant to Rule 804(b)(5) of the Federal Rules of Evidence, four volumes of sworn testimony of a deceased witness, along with hundreds of exhibits and several stipulations, the Tax Court filed two separate opinions on December 26, 1979 (A35) [3] and August 13, 1980 (A177).[4]

The Tax Court's decision pursuant to Rule 155 of the Rules of Practice and Procedure of the United States Tax Court was ultimately entered on August 26, 1981. The Commissioner's Notice of Appeal to the Third Circuit was timely filed on November 23, 1981.

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2. The Tax Court Judge who heard and decided this case, Cynthia Holcomb Hall, now sits on the United States District Court for the Central District of California having been appointed to that Bench by President Reagan on November 20, 1981.

3. 73 T. C. 491 (1979).

4. 74 T. C. 1062 (1980).

The issues in the decision of the Tax Court from which the Commissioner took his appeal arose from the December 26, 1979 opinion and involve the application of a special provision of the Internal Revenue Code (§ 636) to facts found by the Tax Court after the 13-day bench trial. The narrow scope and predominantly factual nature of the Tax Court rulings here in issue has been made plain by subsequent decisions of that court: *e.g.*, *Burns v. Commissioner*, ¶ 78.14 P-H TC (1982) and *Brannen v. Commissioner*, ¶ 78.33 P-H TC (1982); compare, *Smith v. Commissioner*, ¶ 78.26 P-H TC (1982) and *Grodt and McKay Realty, Inc. v. Commissioner*, ¶ 77.89 P-H TC (1981); Hall, J.

The Tax Court below rendered its ultimate findings of fact, as follows (A92-93):

> "The nonrecourse Notes which were included in these transactions had value and commercial reality and were not shams.
>
> "Transactions between CRC (on behalf of itself and the other investors) and the various operators followed a general pattern. In each case the operator would submit to CRC a package of geological prospects to be drilled, along with the lease purchase cost and the drilling contract cost for the proposed package. The operators were aware they would receive cash and a nonrecourse Note; the cash/note ratio was usually 40/60. The operators were also aware that they would receive a completion option, which would entitle them to a share of production if they paid the costs of completing the well and reimbursed certain costs to the Investors.
>
> "CRC and the operators engaged in arm's-length negotiations as to the lease purchase and drilling prices. *The drilling contract terms agreed to were*

always fair and reasonable in light of the contingent nature of part of the price and the risks undertaken by the operator in a no-out turnkey drilling contract. *The lease purchase terms were also fair and reasonable* again considering the contingent nature of part of the price. Moreover, *the total consideration which the Investors gave to the operators—cash, the Note and the completion option—was fair and reasonable compensation for the leases and the services performed and contributions made by the operators.* The transactions were integrated wholes, and the Notes were an integral part of these transactions.

"The Notes were nonrecourse and were secured, in economic reality, only by the oil and gas found. The Notes were cross-collateralized, so that production from any one prospect within a package secured the entire Note. Although the Notes were also secured by the equipment on the leasehold and the mineral interests, if all the test wells in a package produced dry holes, this security had de minimis value. If all the wells in a package were plugged and abandoned, the nonrecourse Notes became worthless. The operators viewed the Notes as substantially equivalent to production payments, which are a right to a specified amount of money only out of a specified portion of the production of one or more wells." (Emphasis added.)

So far as is germane to this Petition, the following summarizes the vital factual and legal determinations made by the Tax Court, all of which are amply supported by the record:

(1) The nonrecourse notes constituted production payments, or the substantial economic equivalent

thereof, within the meaning of § 636 and the Regulations thereunder;

(2) Since the collateral (if any) securing payment of the nonrecourse notes, other than mineral production rights, was not economically significant, under the Congressionally mandated Treasury Regulations (Section 1.636-3(a)(2)) and under applicable case law, *e.g., Standard Oil Co. (Indiana) v. C. I. R.*, 465 F. 2d 246 (7 Cir. 1972), the production payments (or their economic equivalent) did not lose their status as such; and

(3) As a consequence of § 636, and the Congressionally mandated Regulations, read in light of the statute's legislative history and Congressional purpose, the notes/production payments create basis in their face amount thereby permitting deduction of the intangible drilling costs paid in that amount by that means.

On November 16, 1982, the United States Court of Appeals for the Third Circuit, after first noting that the companion appeal in *Brountas v. Commissioner* to the United States Court of Appeals for the First Circuit had been resolved adversely to the taxpayers on September 28, 1982 (A29), and that both the *Brountas* appeal and the instant appeal were argued before each court by the same attorney (A32), ruled:

> "Detailed treatment by us of any of these issues would serve no useful purpose. It suffices to observe that the Court of Appeals for the First Circuit properly disposed of the companion appeal arising out of the same trial record." (A32)

That is, the United States Court of Appeals for the Third Circuit concluded, as had the United States Court

of Appeals for the First Circuit in *Brountas*, that § 636 did not provide a source for increased basis and, hence, for deduction of intangible development and drilling costs saying (A31):

> "The essential flaw in the Tax Court's reasoning . . . is that section 636 does not by its terms make any change in the rule that speculative or contingent liabilities may not be accrued and deducted."

The taxpayers in the *Brountas* appeal to the First Circuit have already petitioned this Court for a Writ of Certiorari to that court of appeals and have set forth in that Petition both a Statement of the Case containing the facts material to the consideration of the questions presented in this Petition and a direct and concise argument amplifying the reasons relied on for allowance of the writ as to the instant appeal.

Accordingly, Petitioner CRC Corporation incorporates by reference the Statement of the Case and the Reasons for Granting the Writ set forth in the Petition of Paul P. and Lynn T. Brountas now pending before this Court (see Stern and Gressman, *Supreme Court Practice*, 5th Ed. at p. 448).

CONCLUSION

For the reasons set forth above, Petitioner respectfully requests this Court to issue a Writ of Certiorari to the United States Court of Appeals for the Third Circuit and thereby to review the judgment of that court dated November 16, 1982.

Respectfully submitted,

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